

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 02-0321  
CORPORATE INCOME TAX  
For Years 1996-1999**

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**ISSUES**

**I. Adjusted Gross Income Tax – Nexus and Public Law 86-272**

**Authority:**

*Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967); *Enterprise Leasing v. Dep't of Revenue*, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); *Meridian Mortg. Co. v. State*, 395 N.E.2d 433, 439 (Ind. App. 1979); *National Serv-All v. Indiana Dep't of State Revenue*, 644 N.E.2d 954 (Ind. Tax Ct. 1994). *Dep't of Treasury v. Ice Service, Inc.*, 41 N.E.2d 201 (Ind. 1942). IC 6-3-2-2(a); 45 IAC 3.1-1-38; 15 USC § 381—P.L. 86-272.

Taxpayer protests the imposition of adjusted gross income tax on the proceeds from sales it made to Indiana and other states.

**STATEMENT OF FACTS**

Taxpayer corporation is a California corporation with a wholly owned Subsidiary in Indiana. Subsidiary holds certain manufacturing and operating assets and properties. Subsidiary manufactures metal containers and component parts—as well as metal caps and closures—for Taxpayer and other unrelated third parties. Subsidiary does all of its manufacturing at four plants—all of which are located in Indiana.

When the manufacturing process is complete, Subsidiary stores its finished products either at its own plant or at a third-party warehouse until Subsidiary is instructed by its customer—in this case, Taxpayer—to drop ship its goods to the end purchaser—in this case—Taxpayer's customers. Subsidiary contracts with common carriers for delivery of its goods. Prior to the shipment, Subsidiary prepares invoices and corresponding bills of lading for the product being shipped. Subsidiary prepares this paperwork at the plant location from which the goods are shipped. Subsidiary prints these invoices on generic invoice forms. These invoices instruct the end purchaser to remit payment to Taxpayer directly.

Subsidiary drop ships its products to purchasers in numerous states. During the audit period, approximately 2 percent of the products were shipped to purchasers in Indiana. When Taxpayer's customers receive the product, the customers have the right to accept or reject the shipment. Until a shipment is accepted, Subsidiary retains the legal title to and bears the risk of loss for the products. When a purchaser accepts a shipment, the title for those products passes from Subsidiary to Taxpayer, and then from Taxpayer to its customer, the end purchaser. Each of these transactions occurs at the location of the end purchaser where the shipment is accepted.

Legal title, possession, and risk of loss and damage remain with Subsidiary until the goods are both received by and accepted by Taxpayer's customers. Pursuant to an agreement between Subsidiary and Taxpayer, Taxpayer is obligated to compensate Subsidiary on a monthly basis at a contractually negotiated price for products and delivery costs. Taxpayer's obligation to Subsidiary occurs only after Taxpayer's customers have received and accepted the shipped goods.

Under the agreement, Taxpayer is required to compensate Subsidiary for Taxpayer's purchases—regardless of when Taxpayer receives payment from its customers. Generic invoices sent with the shipments to Taxpayer's customers require that payment for the goods be sent directly to Taxpayer.

In general, Taxpayer's customers deal directly with Taxpayer. These end purchasers also deal directly with Subsidiary on certain issues, such as production schedule changes, product delivery, and product warranty. If, after receiving and accepting the shipment of goods, Taxpayer's customer becomes dissatisfied with the product and reject the goods, Subsidiary is required to indemnify Taxpayer for those rejected goods. Specifically, Subsidiary agrees to warrant that all goods produced for Taxpayer are produced in conformity with Taxpayer's specifications; Subsidiary warranties to Taxpayer that all goods it produces for Taxpayer will meet or exceed Taxpayer's product warranties to its customers. Subsidiary is obligated under the agreement to indemnify Taxpayer for any breach of those customer warranties.

## **I. Adjusted Gross Income Tax – Nexus and Public Law 86-272**

### **DISCUSSION**

#### **Substantial Nexus**

Taxpayer believes it is not subject to adjusted gross income tax in Indiana. Its argument centers on the fact that it is located in California and claims it has no property or payroll in Indiana. Taxpayer claims that it does not have substantial nexus with Indiana pursuant to the Commerce Clause of the U.S. Constitution. Taxpayer cites the following Supreme Court cases in support of its position.

The requirement for a taxpayer to have substantial nexus with a taxing state is the first of four prongs of the test outlined in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). What constitutes substantial nexus was discussed in Quill Corp. v. North Dakota, 504 U.S. 298 (1992). In Quill, the Supreme Court reaffirmed the physical presence standard that it had adopted as the

test for substantial nexus in National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967). Therefore, according to the Supreme Court, a taxpayer must have a physical presence in a state to be subjected to its tax scheme. The Department will overlook, *in arguendo*, the fact that both Quill and National Bellas Hess are use tax cases, as it prefers to address Taxpayer's arguments directly.

Taxpayer contends that it has no physical presence in Indiana. However, when Taxpayer sells goods to its Indiana customers—despite the fact that Subsidiary retains title to the goods for nearly the entire time between the manufacture of the goods and its ultimate delivery—Taxpayer controls those goods and those goods are located in Indiana. That makes those goods inventory, thereby establishing a physical presence in Indiana.

Taxpayer is the parent corporation of the wholly-owned Subsidiary that manufactures, holds, and ships the products that the Taxpayer-parent sells. Subsidiary invoices Taxpayer-parent's customers. These facts are important in establishing the substance and nature of the transactions in comparison to the formality of the transactions. Indiana courts long have held that Indiana determines tax consequences based on the substance, not the form, of a transaction. *See, e.g., Enterprise Leasing v. Dep't of Revenue*, 779 N.E.2d 1284, 1291 (Ind. Tax Ct. 2002). The three primary indicia of ownership of personal property are: title; possession; and control, which includes the right to sell, dispose of, or transfer. Meridian Mortg. Co. v. State, 395 N.E.2d 433, 439 (Ind. App. 1979).

The Indiana Tax Court has stated that "title alone is not necessarily dispositive." National Serv-All v. Indiana Dep't of State Revenue, 644 N.E.2d 954, 959 (Ind. Tax Ct. 1994). The court in Meridian Mortgage stated, "There is a considerable body of law to the effect that holding title alone does not necessarily confer ownership." Meridian Mortgage, 395 N.E.2d at 440. The court went on to discuss the analogy of a trust, in which the trustee has legal title to the property, but it is the beneficiary who is the equitable owner and who is entitled to the benefit and enjoyment of the property. *Id.* The court also provided the analogy of a stockbroker who holds stock for a customer—but legal title does not indicate the true owner. *Id.* The dispositive question is whether the holder of the property is entitled to exercise the incidents of ownership, such as the ability to sell the property.

In this case, Subsidiary does not have the right to sell the items it manufactures once Taxpayer has paid for those items. Information presented to the Department demonstrates that Subsidiary bills Taxpayer each month for product. Subsidiary then holds the product until Taxpayer names the customer to whom the product is to be shipped. The sale between Subsidiary and Taxpayer parent takes place whether or not the product is shipped at the time of payment. When the product is shipped, Subsidiary invoices and bills the customer at the mark-up price set by Taxpayer. These circumstances indicate that the Subsidiary has no discretion as to whom it may sell its product—these products were manufactured for and paid for by the Taxpayer. Taxpayer controls and directs the disposition of the product to the end customer. Under these circumstances, legal title and possession are secondary to the fact that Taxpayer controls this inventory. This control is indicium of ownership, despite the formalities of the transaction.

Taxpayer controls Subsidiary—to the extent that the Department considers Taxpayer and Subsidiary to be in an agency relationship. The Indiana Supreme Court has defined agency as "the relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Dep't of Treasury v. Ice Service, Inc., 41 N.E.2d 201, 203 (Ind. 1942). The carefully constructed and executed business formalities between Taxpayer and Subsidiary make Taxpayer the principal. The manufactured inventory held by Subsidiary is controlled by Taxpayer.

Therefore, the Department finds that Taxpayer has significant physical presence in Indiana to support a substantial nexus with the state in accord with the Commerce Clause and current line of Supreme Court cases.

### **Public Law 86-272**

Taxpayer's next contention is that, even though it has been found to have substantial nexus with Indiana, its income is not derived from sources within Indiana, and that its activities in Indiana constitute nothing more than solicitation of sales and other activities ancillary to those solicitations.

The term "adjusted gross income derived from sources within Indiana" is defined in IC 6-3-2-2(a) to include the following:

- (1) income from real or tangible personal property located in this state;
- (2) income from doing business in this state;
- (3) income from a trade or profession conducted in this state;
- (4) compensation for labor or services rendered within this state; and
- (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 [IC 6-3-2-2.2] of this chapter.

Because Taxpayer is "doing business in this state," IC 6-3-2-2(a)(2) applies. 45 IAC 3.1-1-38 states that a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

- (1) Maintenance of an office or other place of business in the state
- (2) Maintenance of an inventory of merchandise or material for sale, distribution, or manufacture, or consigned goods
- (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
- (4) Rendering services to customers in the state
- (5) Ownership, rental or operation of a business or of property (real or personal) in the state
- (6) Acceptance of orders in the state
- (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 (15 USC 381) to tax its net income.

Under the circumstances discussed above, because the Department finds that Taxpayer has inventory in Indiana, 45 IAC 3.1-1-38 (2) applies. Taxpayer specifically points to IC 6-3-2-2(a)(2) and 45 IAC 3.1-1-38(7) and states that it does not derive income from doing business in Indiana because its acts only constitute the mere solicitation of orders under the protection of Public 86-272 (15 USC § 381). This need not be discussed since the Department has established that taxpayer has inventory in Indiana. This makes an analysis of "acts exceeding mere solicitation" unnecessary. Taxpayer controls that inventory, thus establishing equitable ownership of that inventory.

### **FINDINGS**

The taxpayer is respectfully denied.

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